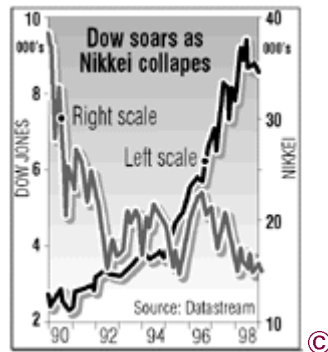


August 23 1998

BUSINESS NEWS



[Special Section - Degree 98: The Sunday Times guide to the latest university vacancies](#)



[Next page: Focus - Branson's pickle](#)

Financial dominoes don't always fall as you expect

THE domino effect is a great financial fear. People remember Black Monday, 1987, when Wall Street contagion sent share prices tumbling round the world. Yet the story of 1997 and 1998 has been the failure of Far Eastern economic turmoil to feed into western markets. If anything, investors have until recently seen Asia's problems as yet one more reason to buy western shares. Those who said Asian flu would soon infect the West have been proved wrong.

Last week was typical. Russia attacked George Soros for suggesting it devalue, then did so, confirming Soros's reputation as an icon financier. In Hong Kong investors were adjusting to the revelation that its government had caught the Japanese habit of propping up share values through purchases. The authorities said the move was designed to squeeze speculators trying to destroy Hong Kong's dollar peg but it is a dangerous escalation in intervention. Hong Kong's government has always used its land to

manipulate property prices but trying to fix share prices is a step too far and may bring chaos closer, not postpone it.

Yet the West sails on, if not totally smoothly (witness Friday's wobbles) at least with a degree of calm few would have predicted. Convention has it that the West is doing well because it has imported from crisis-hit Asia lower commodity prices, lower inflation and lower interest rates. But Woody Brock, the American whose Strategic Economic Decisions firm aims to "identify and explain counter-intuitive structural changes" helping investors to be "less surprised by tomorrow's news than they otherwise would be", quotes Dickens's *Tale of Two Cities* - "It was the best of times, it was the worst of times" - and speculates that something deeper is happening.

Brock reckons two things explain why the West has not caught Asian flu: the West's "postmodern Pizza Hut economies" are more stable than most people believe and more complex - they do not respond uniformly to any given shock. This is a long-term trend even if the oil crises of the middle and late 1970s are factored in. Consumer spending, the least volatile component in gross domestic product (GDP), now dominates. The stock cycle has been made less severe through better management techniques and the decline in cyclical heavy industry. Brock cites a New York Times headline: There's a strike at GM - Anybody watching? Service jobs account for a growing share of the total and service employment is less volatile than manufacturing. Last, activity is less uniform thanks to the increased number and diversity of technologies and markets, both at home and abroad. Brock says: "Reduced correlation has the important 'portfolio' effect of reducing volatility of the economy as a whole."

Such changes could be the reason why western activity has not tumbled in response to reduced exports to Asia. Any shock, from a base-rate rise to a regional crisis, will, one might guess, have less impact on a western country than previously.

The world, or the developed part of it, is also less "correlated" than it was and is thus becoming more economically stable, through the portfolio effect. In his latest bulletin, Brock considers events in the world's main economic engines. "Their electoral cycles are out of sync" he writes. "So are their GDP numbers. So are their banking crises. So is almost everything else. All that seems to be "correlated" is the "hot money" phenomenon that from time to time afflicts the developing economies: global investors periodically pull money out of *all* emerging markets when the going gets rough in *some*."

Japan has been in the sink as China has boomed; France and Germany have been down until recently while America has had a technology-driven surge; Britain has moved out of sync with Euroland. He concludes: "The great paradox is that, for all the talk about a global economy, there *is* no global economy in the sense of a unified structure. Each industry and each nation largely goes its own way." Thus it may be time to bid farewell to the domino theory.

No cure for flu

SO, what did spark Asia's ill-health and what can be done? The consensus view - "hot money flows" destabilised emerging economies that lacked strong, well-supervised banks, were riven by "crony capitalism" and a "lack of transparency" and were too reliant on bank loans - is true but does not go far enough. The real reason is human nature. Brock writes: "Investors held expectations about future returns, which proved . . . to have been unrealistically high. Nothing more than mistakes of this kind are needed to generate the chaotic behaviour that markets have periodically evinced since time immemorial . . . Moreover, there is no reason whatsoever to think that this situation will change in the future if and when we and our policymakers become 'smarter'." Swings from optimism to pessimism, like the poor, will always be with us.

Brock takes on Paul Krugman, who says International Monetary Fund rescues create moral hazard - people put cash in risky situations knowing they will be bailed out. "Without the belief that the authorities will prevent collapse, *underinvestment* on a massive scale would be the result - a state of affairs vastly worse than the small dosage of overinvestment that Krugman seems to fear," Brock writes. "Can you imagine the reaction of pampered, risk-averse Americans if the security blanket of deposits insurance or of the Fed's discount window were taken away by an activist President Krugman attempting to rid us of moral hazards, and to save us from ourselves? No Monica Lewinsky would be needed to get that turkey impeached!"

In reality the institutions that try to restore stability are mismatched to a hot-money era in which cash pours from western funds into securities and loans around the world. Just look at the confusion among "experts". Loose fiscal and monetary policy is urged on Japan but tight policies are deemed right for countries in worse condition. China is urged to keep the yuan stable but other countries must depreciate. The White House and the new administration in Tokyo are all over the place on currency intervention and the yen. "Voilà!" writes Brock. "A classic case of paradigm breakdown. The Best and the Brightest do not understand either what is really going on, or what to do about it. The economic theory they draw on is simplistic, hackneyed and misleading." In private, politicians scratch their heads and new institutions may soon emerge to respond to today's reality. They may not come with a bang. Such a response would be triggered only by a depression. Instead, Brock says: "Change is likely to be lacklustre and incremental. It usually has been." The fear is our leaders do not have a clue what to do.

[Next page: Focus - Branson's pickle](#)

Copyright 1998 Times Newspapers Ltd. This service is provided on Times Newspapers' [standard terms and conditions](#). To inquire about a licence to reproduce material from The Sunday Times, visit the [Syndication website](#).

